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House Financial Services Committee

On the Corporate and Auditing Accountability,
Responsibility and Transparency Act of 2002 (H.R. 3763)

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Mr. Chairman and distinguished members of the Committee, thank you for this opportunity to present my views on H.R. 3763, legislation which I believe will do much to restore the faith of investors in the way in which public companies report their financial results. I commend the Committee for its level-headed and responsible approach, especially at a time when many pundits and commentators are generating more heat than light on these important issues.

I am Joseph V. Del Raso, a partner in the law firm of Pepper Hamilton LLP. My practice focuses on corporate and securities matters, particularly on matters arising under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. I served as an attorney/adviser with the Securities and Exchange Commission in the 1980s, and I serve as a member of the board of directors of both public and private companies. Having experience on the regulatory side, as a lawyer in private practice and as a corporate board member, I believe I offer the Committee an important perspective on the practical effect of key aspects of this legislation.

Because this Committee has already heard a wealth of testimony on the auditor oversight provisions of H.R. 3763, I will focus my comments on other sections, particularly the transparency of corporate disclosure provisions of Section 6, the corporate governance provisions of Section 9, and the credit rating agency provisions of Section 11.

In each of these sections, this Committee should ensure that the studies and activities undertaken do not attempt to fix things that aren't broken. Federal Reserve Board Chairman Alan Greenspan, in his earlier testimony to this committee, noted a pronounced move toward more transparent reporting and improved corporate governance practices in the wake of the Enron collapse. As Chairman Oxley said at this Committee's hearings last week, while the government may still need to take action, that action should not stifle the ability and initiative of the financial markets to self-correct.

Corporate Governance

In my practice as a lawyer and counselor, the vast majority of boards of directors – particularly those of publicly held companies – take their responsibilities very seriously. In the last few years in particular, and I'm sure even more so now in the post-Enron and post-Global Crossing world, independent directors have become increasingly aggressive in acting as watchdogs over their respective shareholders' interests.

Audit committees have already been required to adopt charters governing their operation. Boards also have undertaken initiatives ranging from increased oversight in the area of conflicts of interest – including implementation of corporate codes of conduct and conflict of interest disclosure provisions – to establishing various subcommittees dealing with human resources, diversity and other issues directly impacting corporate and shareholder interests.

Whether or not these policies and procedures are aggressively enforced obviously varies from company to company. On the other hand, given the proclivity of the plaintiffs' bar to act as the self-appointed protector of shareholder interests, even the most diligent board of directors is constantly checking itself to avoid costly, unnecessary litigation. This also serves as an important catalyst for directors' instituting improved corporate governance procedures and policies.

This also points to the need for appropriate government action to craft legislation and implement rules that are clearly understood and not easily manipulated. Appropriate implementation and enforcement is just as critical as the legislative effort. Again, while the actions of the plaintiffs' bar keep directors and officers focused and diligent, the appropriate deterrent is and always will be government enforcement and prosecution. The spectre of criminal sanctions and incarceration for the most egregious misbehavior, or civil fines and sanctions for other transgressions, serves the public interest much more sensibly than allowing the elite of the plaintiffs' bar to further fatten their coffers by extracting or taxing in the form of contingency fees. A more direct distribution of funds to compensate victims of corporate malfeasance, or fines that are used to further bolster government enforcement efforts, are far preferable, and indeed are just plain common sense. Any effort to roll back securities litigation reform will only make business more expensive (by increasing insurance costs, for example) and less productive. Prosecutorial judgment is a markedly more effective approach than "strike-suit" targeting.

Below the board level, the President's Working Group referred to in Section 9 should examine how the financial markets can deter managers and other employees from interfering or influencing third-party professionals, whether they be auditors, outside counsel, rating agencies or other parties that are relied upon in one way or another to put their imprimatur on corporate actions.

The questions that are raised in Section 9 as to audit committee independence and standards are worth further study, but I would submit that significant progress was made with the recent requirement set down on audit committees to implement audit committee charters.

From a practical perspective, any additional government overlay, from either a statutory or regulatory standpoint, may further dampen the enthusiasm of **qualified** people to serve as independent directors. The overwhelming majority of independent directors have been and continue to be good corporate citizens dedicated to discharging their duties to protect shareholder interests. They are keenly aware of the realities of shareholder litigation, the parameters surrounding appropriate indemnities, and the finite limits of directors' and officers' liability coverage if the corporate indemnity is insufficient.

Further initiatives, including personal liability expenses – except in the most egregious cases of willful, wanton misconduct – and onerous regulatory sanctions, may merely serve to deter these individuals from accepting positions as independent directors.

Finally, corporate governance ties in with the provisions in Section 6 regarding the need for improved transparency of corporate disclosures. Boards should be able to discern from transparent reporting the correct state of affairs – there should be little excuse for a well-informed board of directors to fail in the way of those who were victimized by obfuscation and financial hijinks, under the ruse of off-balance-sheet transactions and other clever financial tricks. Uniform standards of financial reporting will not only sustain a level playing field, but will uphold the integrity of the process

I applaud the work of this Committee in seeking improved transparency, for without it, the efficient functioning of our financial markets may be impeded. Financial investors expect to see – and will demand more than ever – quality of earnings that can only be reported via clear and concise accounting standards, consistently applied. This is especially true when dealing with non-exchange-traded financial instruments and other investments that are not readily tracked in the public markets. This legislation will help put the "fair" back in fair-value accounting.

Credit Rating Agencies

The area of credit rating agencies warrants the study and consideration outlined in Section 11. I am especially heartened that the Committee has recommended not only that this will be studied, but that barriers of entry into the credit rating business will be carefully evaluated. Qualified firms should be afforded access to this business.

On the other hand, it must be clear that the function of a rating agency is most important. The integrity of the work product of these agencies is critical to the efficient operation of the securities markets.

Many of the issues I noted regarding the corporate governance procedures also apply to credit rating agencies, particularly the overwhelming need to avoid conflicts of interest. This again is essential to the efficient operation of the financial markets. Just as with the "seal of approval" the independent accountant provided with certified financial statements, the "grade" awarded by the rating agency will only be worth the strength and integrity of the name behind it.

Conclusion

Mr. Chairman, thank you again for the opportunity to testify today on this important piece of legislation. The dark cloud of the Enron and Global Crossing collapses, while obviously dire to investors, employees and others most immediately affected, may have some element of a silver lining if, as I believe, it serves as a wake-up call to responsible independent directors and corporate officers, and if it provides the Congress the impetus to enact some long-needed reforms to ensure responsible reporting of corporate financial results.